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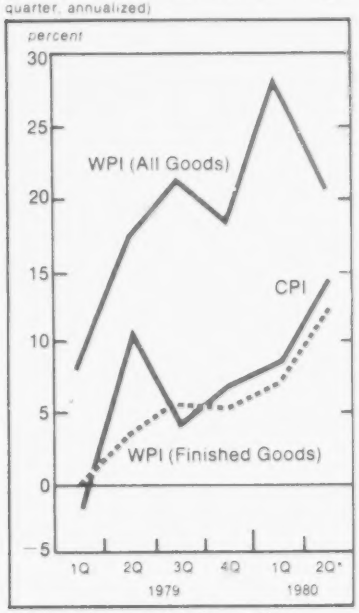
The Outlook for Inflation in Japan

Inflation is now hitting the Japanese consumer with a vengeance. Although wholesale prices accelerated sharply in early 1979 following the first round of OPEC price hikes, consumer prices lagged well behind. As late as last November the Japanese consumer price index was up less than 5% on a year-over-year basis, while wholesale price increases were well into the double-digit range. Since then consumer prices—as well as wholesale prices—have climbed rapidly. Wholesale price inflation appears to have peaked in April—with the overall index up 24% above the level of April 1979—and is now abating. The peak in consumer price inflation is yet to come, however. In May the consumer price index stood more than 8% above the level of a year ago. By August the year-over-year rate of increase of consumer prices should reach 11%. And the inflationary momentum already built into the price structure implies that consumer price inflation is unlikely to fall below the double-digit level on a year-over-year basis before early 1981.

Japanese inflation rates
(Quarterly average price rises over preceding quarter, annualized)



*Estimate based on data through May

This inflation outlook is obviously bad news. Nonetheless, there is a message hidden in the numbers that can be of some cheer to the Japanese policymakers. The inflation thus far is mainly imported rather than homegrown. And the combination of wage restraints, high productivity growth, and fiscal-monetary tightness will moderate imported inflation. Thus, the indirect or secondary effects of the OPEC price actions on domestic inflation should be felt less severely in Japan than in most other industrialized countries. The spring wage offensive settled for a surprisingly moderate 6½-7% increase in wage rates. And although productivity growth in manufacturing in unlikely to match last year's 12% increase, it will continue at a relatively high rate. Between now and yearend the rate of wholesale price inflation in Japan should fall sharply, even if the yen does not strengthen significantly from its current level.

Barring another quantum leap in the price of oil, this downward trend in wholesale price inflation in Japan should continue well into 1981. And if it is further assumed that there will be no significant relaxation of monetary policy, the pace of consumer inflation should decelerate noticeably in the first half of next year. Thus, while the consumer price index in fiscal-year 1980 (April 1980-March 1981) will probably average roughly 10% higher than in fiscal 1979, the rate of inflation facing the Japanese consumer could fall back to moderate levels in fiscal 1981.

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Canadian GNP declined in the first quarter.

The Canadian recession is now confirmed. Statistics indicate an annualized drop in real GNP of 2% during the first quarter. The drop was mainly the result of declines in residential construction and exports, as well as weak consumption spending and the deepening U.S. recession. Bolstering the economy against an even larger decline has been the Government's deficit spending, in addition to the large reserve of personal saving that is helping to support consumer spending. The quick downturn has helped contain inflationary pressures. The rate of inflation has been held below 9.5%, while the fall in output has produced a moderate increase in unemployment from 7.3% to 7.8% between December and May. These trends suggest a mild economic downswing over the course of the recession.

Portuguese authorities encouraged in anti-inflation battle.

As Portugal moves toward general elections in October, the importance of economic issues is mounting. The center-right Carneiro Government, in power since December, has pledged to reduce inflation from its 1979 rate of more than 24% to under 20%. It appears that the goal will be attained, following a 6% revaluation of the escudo in January, along with higher subsidies for basic commodities. Most recent reports peg the year-over-year inflation rate at 19.6% and falling. This has encouraged the authorities to reduce the monthly crawling-peg devaluation to 0.5% from 0.75%, which should lower inflation further. In the meantime, however, the labor unions have fomented industrial unrest on several occasions, clamoring for increased wages. And longer-term prospects have been clouded by recent French opposition to the enlargement of the European Community. Portugal had hoped to complete negotiations and begin receiving substantial EEC aid in 1981, prior to its entry at the beginning of 1983. French objections may now delay the timetable slightly.

Turkey obtains IMF standby, commits itself to economic restructuring.

The recently approved $1.65-billion IMF standby loan marks the IMF's approval of the new Turkish Government's economic policies. It also implies continued relative economic austerity over the next three years. The country's recent economic performance has been far from encouraging. Real GDP showed virtually no growth last year, and April inflation rose to a year-over-year rate of 117%. On the external front, January-April exports in dollar terms rose an estimated 7.3%, to an annual rate of $2.7 billion, while imports advanced 6.1% to an annual rate of $5 billion. The current account is now expected to register a deficit of at least $3 billion this year. More encouraging is the Government's commitment to freeing interest rates to boost savings, reducing subsidies to state economic enterprises, and limiting the growth of the central bank's net domestic assets. Any economic restructuring, however, will take time, and Turkey's heavy debt-service burden, energy dependence, and the import-intensity of its industry ensure that it will continue to require large amounts of foreign assistance over the next three years.

Despite lower oil output, Iran posted a large current-account surplus in 1979.

The Iranian current account posted a surplus of approximately $11.5 billion in 1979, compared with a near-balance position in 1978. This marked improvement occurred despite a 42% drop in oil output from an average 5.2 million barrels per day in 1978 to 3.1 million bpd last year. It was essentially the result of two developments: higher oil prices and reduced imports. The average oil export price (including spot-market sales) soared 84% from $12.65 per barrel in 1978 to an estimated $23.30 per barrel last year, bringing total oil revenue to $20.5 billion in 1979, just about the same as in 1978. At the same time, purchases from abroad fell off sharply. Merchandise imports declined to approximately $8 billon from $18.5 billion in 1978. This year, the current-account surplus will be relatively small, at best. With the loss of Japanese and several European customers, Iran's exports of crude oil and refined products have fallen to a current level of some 800,000 barrels per day. Official prices have been maintained at the average level of $34.87 per barrel (including premiums) since April 1, with some discounting reported. If Iran sustains its present prices and boosts exports to an average one million barrels per day for the

year, while holding average imports to no more than $9 billion, it will post a current-account surplus of $1.5 billion in 1980. This would be insufficient to cover current budget needs and would require a large drawdown of international reserves, which stood at $14.7 billion in January.

Norwegian authorities under increasing pressure to alter policies.

Huge oil reserves and a small population make Norway's long-run economic prospects highly favorable. Indeed, this year's oil production will be sufficient to give Norway a current-account surplus in 1980, while every other European nation will likely post a deficit. Nonetheless, short-term problems exist. Inflation, which averaged 4.8% last year, has accelerated steadily, reaching 9.4% in May and promising a double-digit average for 1980. The resultant reduction in competitiveness threatens Norway's export industries, and the non-oil sector is expected to show almost no growth over the next 18 months. Consequently, pressure is mounting for a change in government policy. In this context, the Norwegian Federation of Industry has accused the authorities of expanding the public sector's role at the expense of private economic activity. It is calling for a tighter budget in 1981 and a freeze on public-sector employment.

Brazilian exports strong, but greater import restraint is vital.

After a string of monthly trade deficits so far this year, Brazil posted a merchandise surplus in May, the first monthly surplus since 1978. The trade account was in the black by a total of $10.5 million for the month, with exports of $1.94 billion and imports of $1.93 billion. The country's cumulative trade balance for the first five months, however, stands in deficit by $1.81 billion. Although exports have risen at a 34% annual rate during the first five months of 1980, imports have soared at a 50% rate over the same period, paced by higher oil costs. The export performance has been surprisingly strong, given the slowdown in world economic growth, but greater restraint is clearly needed on the import side. Recognizing this need, the Government has just requested a new $1.1-billion reduction in public-sector imports and a $2.6-billion cut in spending by state companies. Such restrictions, coupled with the hoped-for slowdown in overall demand, should reduce future import needs. But Brazil will still be hard pressed to keep its 1980 trade deficit as low as the $2.7 billion of 1979.

Taiwanese export-led economic growth will weaken in 1980.

The Taiwanese economy expanded by a real 7.4% in 1979, accompanied by an inflation rate of 11.3%. The rapid growth has been sustained in the first half of 1980, with real GDP growth running at an estimated 7% annual rate. Exports continue to lead the rest of the economy, with earnings for the January-April period up 28% above the year-earlier level, and volume up 15%. This strong export performance, however, is unlikely to continue through yearend, with a recession unfolding in the United States, Taiwan's principal market. In the meantime, inflationary pressures are mounting. Substantial wage increases and higher import prices have boosted the inflation rate to about 15%, a serious concern for the financially conservative government. For 1980 as a whole, Taiwanese economic growth is expected to slow to approximately 5%, a result of more restrictive monetary control and the weakening of exports.

Singapore's economy responds well to new industrial strategy.

Singapore's new industrial strategy appears to have got off to a good start. GNP grew by a real 9% in 1979, the first year of the plan's implementation. Manufacturing, which critics of the plan thought would be hurt by the strategy's high-wage policy, posted a real gain of 14%. The inflationary impact of higher wages was largely offset by productivity gains and a strong Singapore dollar, and consumer price inflation was kept to 4%. Prospects for 1980 remain bright, despite the increasing economic weakness in the West. Manufacturing is expected to continue to provide the major stimulus. Stepped-up oil exploration has firmly boosted the shipbuilding and industrial machinery sectors; the petrochemical industry is attracting heavy investment; and the electronics industry is undergoing a technological upgrading in response to the high-wage policy. Over all, real economic growth of approximately 8% and inflation of about 6.5% are expected for 1980.

Saving Bounces Back—But How High?

Now that consumers have put away their credit cards, personal saving is showing signs of reviving. From late last summer, through the autumn and winter months, personal saving as a percentage of disposable income languished at rates far below the post-World War II average. Recent Government reports, however, show a hardy turnaround in the proportion of income that consumers choose to save.

The savings rate in May rose to 4.9%, considerably more robust than the 29-year low of 3.5% recorded in January. Historically, consumers have elected to put aside an even greater share of after-tax income—more in the neighborhood of 5½%-6%—which suggests that there is room for the rate to rise still further. But given present economic circumstances, it is not clear how much higher the savings rate will climb.

Consumers are clearly going through a period of retrenchment, spurred by the continued decline of real income and the Federal Reserve's drastic measures to curb the use of credit. An easing of inflationary expectations, coupled with a growing concern over the severity of the current economic downturn, has subdued consumers' frenzied buying to beat future price increases—for the moment at least. Consumer expenditures are down, particularly durable goods purchases. And the latest report on consumer credit showed that instalment credit outstanding plunged a record $1.99 billion in April, the first decrease in consumer credit since May of 1975. The upcoming statistics for May 1980 are expected to show another hefty decline.

Whether consumers will continue to increase their saving will depend largely on what they perceive to be happening to the economy. Historically, in periods of rising unemployment and increasing economic uncertainty, consumers have increased their rate of saving as a precautionary measure. The significance of this motive for saving has diminished over the years, however, as higher unemployment benefits have reduced the hardship of joblessness, and as government policymakers have demonstrated an increasing propensity to enact stimulative policies in times of economic decline.

Since the current political climate makes a tax cut a virtual certainty, consumers' expectations of this legislation may well revive their interest in spending. On the other hand, the tax "cut" may prove to be illusory. It is not likely that any reduction in tax rates on personal income will be sufficient to offset the increased consumer tax bite in 1980-81 from higher payroll taxes for Social Security and "bracket creep" caused by inflation.

In any event, there is considerable uncertainty over the direction of any consumer response to tax cut legislation. If consumers interpret a tax cut proposal as a sign that policymakers have abandoned the fight against inflation, they could start another round of panic buying that could torpedo savings again.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS 3 months ending	EXPORTS Change from year earlier	GNP in 1978 in billions of dollars	GNP in 1978 per capita	BALAN latest data	reserves (less gold) in million $	12-month change	months of imports covered	li
Africa	Algeria	Agreements reached with SOHIO and France's CFP on oil exploration programs.	Mar.	+ 95%	24.6	$ 1,374	Apr.	3,312	+ 53%	5.3	
Africa	Cameroon	Real economic growth running at 6% per annum; domestic market very buoyant.	June '79	+ 13%	4.0	500	Dec.	126	+140%	1.0	
Africa	Egypt	New budget provides for larger basic commodity subsidies and higher public-sector wages.	Dec.	+121%	16.4*	400	Jan.	760	+ 34%	2.5	
Africa	Ivory Coast	Budget for 1980 increases investment spending by a nominal 30%.	Nov.	+ 30%	7.6	1,440	Feb.	26	— 94%	0.1	
Africa	Liberia	Economic stagnation continues, with no improvement in sight.	Oct.	— 5%	0.9	525	Apr.	40	0	1.0	
Africa	Malawi	Development expenditure down sharply, owing to worsening fiscal situation.	Dec.	+ 25%	1.3*	225	Apr.	46	— 10%	1.5	
Africa	Morocco	Expansion of cement and sugar output under study; World Bank lends $34 million for agriculture.	Dec.	+ 19%	12.8	678	Mar.	334	— 23%	1.3	
Africa	Nigeria	Civilian government seeks to expand agri- and manufacturing industries.	Mar.	+ 93%	50.7*	625	Apr.	6,697	+235%	6.1	
Africa	Senegal	Forthcoming revision of investment code should enhance investment climate.	n.a.	—	2.3***	430	Feb.	15	— 47%	n.a.	
Africa	Sierra Leone	Economic deterioration continues; crash program instituted to stimulate rice production.	Dec.	+157%	0.7	210	Apr.	55	+ 36%	1.6	
Africa	South Africa	Private spending fuels GDP growth of an estimated 6% in 1980; investment boom not far off.	Mar.	+ 71%	57.3*	2,070	Apr.	679	— 5%	0.8	
Africa	Sudan	New projects will be aimed at eliminating infrastructural bottlenecks.	Oct.	+ 55%	9.1*	508	Apr.	54	+116%	0.5	
Africa	Tunisia	Industrial output rose 10.3% in 1977, led by energy and construction.	Dec.	+ 52%	5.9	966	Apr.	629	+ 70%	2.8	
Middle East	Iran	New emergency budget based on oil revenue of $10 billion this year, vs. over $20 billion in 1979.	Mar.	+700%	76.4***	2,227	Jan.	14,702	+ 24%	23.0	
Middle East	Iraq	Expenditures on infrastructural development rising sharply.	Mar.	+122%	23.3	1,875	n.a.	—	—	—	
Middle East	Kuwait	Kuwait Oil Tanker Co. plans to expand its fleet from 15 ships to 27 by end-1982.	Mar.	+ 61%	13.9**	12,278	Apr.	2,564†	— 4%	6.8	
Middle East	Saudi Arabia	Budget for 1980/81 sets $73.6 billion in expenditures, up 27% from actual spending last year.	Mar.	+ 95%	54.5**	8,400	Apr.	19,744†	+ 13%	9.5	
Middle East	United Arab Emirates	Federal budget allots $514 million for investment projects.	Mar.	+ 87%	13.8	19,435	Apr.	1,430†	+ 60%	3.2	

*1979 **FY 1977/78 ***1977 †Excluding state r

Monetary Policy: To Ease or Not to Ease?

The meeting of the Federal Reserve's Open Market Committee (FOMC) this Wednesday is considered especially important by money market participants. At this meeting the FOMC will review its current growth targets for the monetary aggregates and lay the groundwork for Chairman Paul Volcker's semiannual congressional testimony July 22. Federal Reserve actions in the credit markets following the July 9 meeting will be examined closely for insights into the Fed's current strategy of monetary policy.

As usual, there is widespread disagreement over what will be decided at the upcoming FOMC meeting. Those who maintain that the Fed will lower its trading range for the Federal-funds rate base their argument on recent slow money growth and the weakness of the economy. At the time of the FOMC meeting, the two most widely watched monetary aggregates, M_{1a} and M_{1b}, will almost certainly be below their target growth rates set earlier this year—despite double-digit money growth in June. The most recent bank-loan and consumer-credit data are also likely to show extraordinarily weak growth. Furthermore, economic data released prior to the meeting should indicate a further slowing in economic activity. Some observers argue that because of these forces—and because the Fed must go before Congress and explain the coincidence of slow money growth and a severely depressed economy—the FOMC will decide that further credit-easing is warranted.

Others, however, contend that the Committee will not lower its Federal-funds rate target. They point out that money growth has begun to accelerate in June, and that the Committee is concerned that further acceleration in the near term may result from recent sharp declines in interest rates and from a large increase in Social Security payments in early July. This prospect, they believe, will lead the FOMC to hold off on any further rate declines. They also note that growth of the broader M_2 aggregate in June should be near its targeted level, and they believe that many members of the FOMC place significant weight on the behavior of this aggregate. They also argue that any further decline in U.S. short-term rates will cause the dollar to depreciate further on the foreign exchange markets, and that this potential will be weighed heavily at the July 9 meeting. Finally, they argue that further rate declines will be viewed by the FOMC as unwarranted in the light of recent inflation data.

To some extent these different opinions reflect the divergent views among the members of the FOMC itself. Many economists—including those within the Fed system—have noted that there are significant disagreements among FOMC members over the proper role of monetary policy, as well as over the relative weights that should be attached to various economic data in formulating monetary policy. Thus, Fed-watchers will be watching the Fed especially closely later this week for signs of any policy change.

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
e of IMF edit, millions of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars July 1, 1980	current monetary conditions	
0	Negotiations on LNG export prices resumed with France.	June '79	+ 14%	Sept.	+ 28%	—	.2725	A $242.5-mn. export finance package signed with France.	Algeria
0	Trade deficit shows improvement, despite lower cocoa earnings.	Nov.	+ 8%	Dec.	+ 14%	—	.0049	Net foreign assets in surplus.	Cameroon
301	Suez Canal revenue rising sharply.	Dec.	+ 15%	Jan.	+ 20%	10.00%	1.45	Foreign banks must put 15% of fx deposits in central bank.	Egypt
0	Weak cocoa price and coffee crop preclude current-account improvement.	Feb.	+ 16%	Sept.	+ 28%	8.00%	.0049	External debt-service costs soar.	Ivory Coast
38	Trebling of ship tonnage tax should double 1980 revenue.	Nov.	+ 13%	Nov.	+ 39%	—	Par	Credit is restrictive.	Liberia
7	Stepped-up industrialization will require growing imports in 1981.	Feb.	+ 17%	Mar.	+ 29%	10.00%	1.26	Credit restraint aimed at curbing imports.	Malawi
193	Austerity program slows growth of imports.	Feb.	+ 8%	Feb.	+ 12%	4.50%	.2600	Money supply expanding more slowly.	Morocco
0	General import restraint continues, despite selective relaxation.	July '79	+ 10%	July '79	+ 14%	5.00%	1.915	Interest rates will be raised to to spur savings.	Nigeria
55	Higher food imports and poor export earnings portend payments weakness.	Dec.	+ 9%	Sept.	+ 35%	8.00%	.0049	Credit growth being restricted.	Senegal
35	Bunching of 1980-82 debt repayments eased by $120-mn. rescheduling.	Dec.	+ 21%	Feb.	+ 31%	—	.9925	Credit to public sector expands strongly.	Sierra Leone
62	Trade surplus narrows in April-May, as exports contract and imports rise.	Mar.	+ 13%	Feb.	+ 12%	7.00%	1.3010	Credit demand rises sharply.	South Africa
250	Lower cotton earnings and poor prospects for other exports this year.	Mar. '79	+ 27%	Feb.	+ 26%	—	2.0225	Need for balance-of-payments support continues.	Sudan
31	Oil output holding steady at 100,000 barrels per day.	Jan.	+ 11%	Feb.	+ 10%	5.75%	2.55	World Bank lends $37 million for TransMed pipeline link.	Tunisia
0	Oil exports down; official price held unchanged since April 1.	Feb.	+ 15%	Sept.	+ 12%	9.00%	n.a.	Emergency budget points to faster rise in bank credit.	Iran
0	Oil revenue supports continued increase in imports.	Sept.	+ 12%	n.a	—	—	3.41	Credit generally available.	Iraq
0	Oil export price raised $2 per barrel.	Dec.	+ 5%	Feb.	+ 35%	—	3.75	Drop in Eurodollar rates reduces outflow of private funds.	Kuwait
0	Oil output and prices held constant, but future strategy uncertain.	Dec.	+ 2%	Jan.	+ 87%	—	.3015	Credit to private sector increasing rapidly.	Saudi Arabia
0	Abu Dhabi holds oil export price constant.	n.a.	—	Feb.	+ 8%	—	.2713	Bank loans to private sector increasing.	United Arab Emirates

World Interest Rates

market rates of July 2, 1980; bond yields as of June 30, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	10.63	17.00	13.00	9.50	7.50	15.00 penalty rate 18.00	9.50*	3.00	9.00
Day-to-Day Money	9.25 July 2	13.00	17.25	13.00	12.50	10.50	16.875	10.50*	3.50	12.6875
Treasury Bills 91-day, Middle Rates	8.09	10.50	15.625	13.75	12.40 one-year	n. a.	14.45 90-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	7.625 finance paper	11.50 finance paper 15% tax w/h	14.71	12.90 Certified	12.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.65	11.40 15% tax w/h	16.125	12.90 Certified	not traded	9.90	18.50	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.00	11.80	13.38	10.76 20% tax w/h	12.96	8.01	15.34	9.87*	4.72	8.22
Industrial Bonds prime, long-term, new and old issues, average yield	11.10 Aa Industrials	12.20	13.98	14.09	13.88	8.01	15.32	10.73*	5.61	7.40
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.25	18.00	18.25	14.60	11.50	20.00	12.50*	5.50	9.25
Bank Time Deposits 3-month	8.00 Cert. of Dep.	11.40 Cert. of Dep.	16.8125	13.70	12.50	9.85	10.75	10.50* large deposits	5.625 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.6875	no market	17.0625	no market	12.625	9.5625	no market	10.5625	5.75	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8691	2.3585	.035508	.2448	.5677	.001187	.5190	.6156	.004562
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.85 *D*	7.05 *D*	3.80 *D*	2.75 *D*	.28 *P*	18.50 *D*	.85 *D*	4.10 *P*	2.45 *D*

Eurodollar Deposits
(London interbank, bid) July 2

7-day	9.3125
1-month	9.3125
3-month	9.375
6-month	9.5625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .27
U.S.-Canada Treasury Bills	− .19
U.S.-Canada Finance Co. Paper	−1.87
Eurodollars-U.K. Local Auth. Deposits	− .39

Eurobonds
(average yield on recent straight debt issues)

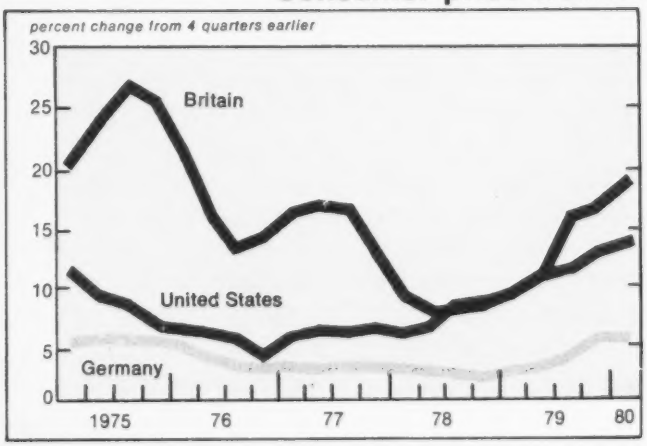
U.S. Dollar Bonds	
7 yrs. and under	10.75
Over 7 yrs.	11.00
DM Bonds	
7 yrs. and under	7.875
Over 7 yrs.	8.00

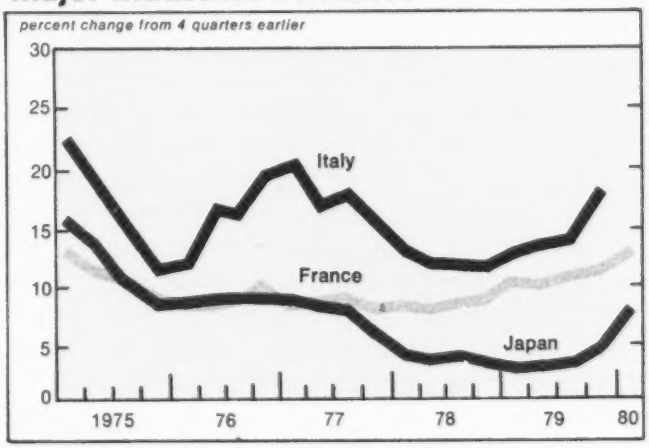
Gold Price
London afternoon fixing
661.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of June 25; bond yields as of June 20.

Consumer price trends in major industrial countries





Austria Maintains Anti-Inflationary Policy

Austria's economy is small and open, but well-developed and diversified. While agriculture has declined in relative economic importance at the expense of the services sector, a common evolutionary feature of developed economies, the external sector continues to dominate economic activity. Exports and imports together account for about 50% of GDP.

The unusual economic trend on the Austrian scene is the declining importance of manufacturing. The share of mining and manufacturing in total GDP fell from 34.5% in 1970 to 29.8% in 1978. This is the direct result of an exchange-rate policy that reflects the authorities' willingness to accept the deflationary consequences of a strong currency in the interest of minimizing inflation.

Austria's "hard-schilling" policy was instituted in 1973 with the tying of the nation's currency to the German mark, a logical choice since Germany is Austria's most important trading partner. The linkage boosted the trade-weighted value of the schilling and initially dampened Austrian export price competitiveness. But the strong currency also cut import prices, and since much of Austria's industrial output is tradable and in direct competition with imports, Austrian firms were constrained in raising domestic prices. While this did hold down inflation, it also squeezed industrial profits and encouraged a shift in production out of traded goods and into services.

The firm-exchange-rate policy eventually reduced the rate of labor cost increase, so that between 1977 and 1979, industrial unit labor costs in schilling terms showed virtually no increase. This allowed Austrian international competitiveness to remain nearly unchanged through mid-1979, after which it worsened again as the schilling was revalued in response to a DM revaluation.

The economy in 1979

The Austrian economy turned in one of the strongest European growth performances last year. Real GDP rose 5.2%, one of the highest rates in the OECD. Real consumption increased 5.1%, investment rose a real 9.3%, and export volume climbed nearly 11%.

This growth was essentially confined to the private sector, as fiscal policy was not expansive last year. Government spending as a percent of GDP even declined slightly, from 25.8% in 1978 to 25.7%, and the net budget deficit fell to 3.5% of GDP from 4.2% in 1978. Nonetheless, the Government's debt-service burden continued to increase rapidly. Debt service as a proportion of total Federal spending jumped from 9.6% in 1977 to 11.7% last year.

Monetary policy was similarly restrictive in 1979, largely aimed at maintaining the schilling's parity with the mark. Austrian interest rates have thus tended to follow those in Germany, adjusted for such other factors as the current-account balance. Consequently, rising German interest rates and a widening current-account deficit forced an increase in Austrian interest rates in late 1979 and early 1980.

The authorities were reasonably successful in fighting inflation last year. Consumer prices rose by only 3.7%, compared with 3.6% in 1978, as industrial unit labor costs dropped 0.5%.

The only Austrian economic indicator that performed poorly last year was the balance of payments. The trade deficit widened from $3.6 billion in 1978 to $4.5 billion. And despite an improvement in Austria's traditionally positive invisibles balance, the current-account gap widened from $1.4 billion in 1978 to $1.9 billion.

Fiscal policy has continued to be restrictive in 1980. As a result, the net Federal government borrowing requirement is expected to fall to 3.1% of GDP. (A recession in the latter part of the year, however, may well raise this figure.) Monetary policy will also continue restrictive, and interest rates may have to be boosted further before they begin descending late in the year, in a lagged response to falling German rates. The inflation rate, however, is expected to rise to about 6%. And with the savings ratio unlikely to drop, the consequent erosion in the real value of nominal earnings will keep real consumption growth to no more than 2.25%. Investment spending growth is also forecast to slow, to about 3.5%. On balance, Austria will post real economic growth of about 2% in 1980.

On the external front, substantial deterioration in the balance of payments is expected this year. The German economic slowdown will hold Austrian export volume growth to some 5%, while higher oil costs will strongly boost import expenditures. With petroleum prices expected to average 60% more than in 1979, Austria's oil import bill will swell by about $1 billion to approximately $2.8 billion. This sharp increase will help widen the current-account deficit to an estimated $3 billion.

The economy is likely to continue weak through 1981. Real GDP growth is provisionally estimated to drop to 1.5% next year, a result of restrictive policies and continued high payments deficits stemming mainly from higher oil bills. Indeed, with the resource cost of further energy conservation greater in the 1980s than in the last decade, Austrian growth—along with growth throughout the industrialized West—is likely to remain relatively depressed for the next five years or so.

George de Nemeskeri-Kiss
Chase London

The Euromarket and the OPEC Surplus

When the Organization of Petroleum Exporting Countries set off the first round of oil price hikes in 1974, many observers sounded the danger alarms for the international banking system. Bankers wondered how $65-billion worth of OPEC surplus funds could possibly be channeled to the countries that required them without the entire system breaking down. The Eurocurrency market, however, met with no problem in recycling the surplus. Indeed, the Euromarket has demonstrated that it is perhaps the most efficient and resilient money market the world has known.

The international economy is now adjusting to another major oil price shock. Predictably, the alarms are being sounded again, albeit somewhat more reservedly. Equally predictably, the Eurocurrency market appears to be functioning as efficiently as ever. Circumstances are somewhat different this time around, however.

First, when oil prices exploded in 1974, the Eurocurrency market was less experienced in making large loans to national borrowers. Consequently, the cost of these loans—the spread over LIBOR—was often quite high, and the time necessary to complete a large financing was often interminable. However, deficit countries did succeed in obtaining the financing they required. Between 1974 and 1979, the Eurocurrency market gained much experience in lending and in risk assessment. During that same time, the actual risks of international lending declined, partly because of the relative calm on the oil market. The spreads on Euromarket syndicated loans therefore fell dramatically. With the onset of the latest round of oil price increases, these spreads will undoubtedly rise, but only a small number of countries will be charged the same high spreads that prevailed in 1974.

Second, some national borrowers have begun to diversify into bond markets during the last half-decade. In 1974, the less-developed countries (LDCs), including the oil exporters, obtained only about 9% of their external financing through international bonds. By 1977, these same countries were satisfying about 19% of their needs through bonds. Thus, while external financing pressures on the Eurocurrency market will arise during the current recycling, the international bond market will be playing a small but continually growing role.

These developments should minimize the difficulty of the current recycling challenge. But some new serious problems do exist. Perhaps most important is the impact that this OPEC round will have on the economic growth rates of the developing countries. For the most part, the LDCs were spared most of the real growth consequences of the first round of oil price hikes. This is because they were relatively underborrowed in 1974 and had the flexibility to increase their debts to pay their oil bills without having to curtail investment projects. Currently, the LDCs are much nearer their "appropriate" debt/growth ratios, and are, in many cases, up against their borrowing limits with the major Western banks. Consequently, there are likely to be some real growth effects this time around. The era of very rapid annual economic growth for some LDCs may evolve into a decade of still rapid but much more restrained growth.

The realization that slower growth for certain LDCs is virtually inevitable is what most concerns world leaders in the current round of recycling. To be sure, the Euromarket will assist in recycling the OPEC surplus once again. And the multilateral lending institutions, such as the World Bank and the IMF, may be able to support countries with the most severe adjustment problems. But this time, the non-oil developing world will probably have to pay the painful price of forgone economic growth.

Bluford H. Putnam

Eurocurrency Market

($ billion, end of period)

Total Market Size	IIQ/79	IIIQ/79	IVQ/79	IQ/80	1978	1979	1980
Gross Size (Claims)	946.6	1,041.5	1,110.9	1,100.0	892.7	1,110.9	1,350.0
Net Size (Claims)	585.0	635.0	665.0	670.0	535.0	665.0	825.0
Liabilities to Private Nonbanks	155.0	165.0	170.0	172.0	140.0	170.0	210.0
Claims on Private Nonbanks	295.0	310.0	320.0	320.0	280.0	320.0	365.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	243.8	260.8	273.4	270.0	222.7	273.4	330.0
Liabilities to Private Nonbank Foreigners	57.6	61.9	62.3	64.0	54.8	62.3	72.0
Total Claims on Foreigners	306.1	330.7	338.6	335.0	293.0	338.6	420.0
Claims on Foreign Public Borrowers	36.1	39.6	41.3	42.0	33.9	41.3	55.0
Claims on Foreign Private Nonbank Borrowers	107.6	113.1	118.6	120.0	104.2	118.6	140.0

Note: Gross and *net* Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.